FINAL TRANSCRIPT

Thomson StreetEvents℠

**ACC - Analyzing the New Section 409A Guidance: Answers and Remaining Issues

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PRESENTATION

Michael Wyatt - *WellPoint Inc. - Vice President and Deputy General Council and*

Good afternoon. This is Michael Wyatt, I am Vice President and Deputy General Council of WellPoint Inc and the current chairman of the Associated Corporate Councils, Corporate and Securities Law Committee, which is sponsoring today's webcast. I am pleased to be the moderator for today's webcast. And I'm pleased to have with me today Daniel Hogans who's an Attorney Advisor in the Office of Tax Politics for the US Department of Treasury in Washington. Also with us today are Mark Wincek, a Partner with Kilpatrick Stockton in Washington DC and the leader of the firms Benefit and Compensation Practice.

We also have Lois Colbert, also a partner with Kilpatrick Stockton and Jennifer Schumacher, another partner with Kilpatrick Stockton. Steven Tackney and William Schmidt of the IRS were scheduled to participate today but are unable to join us, however no one knows these new regs under 409A better than Dan Hogans of Treasury, so I'm sure we're going to be in good hands.

Just a week ago today, treasury and the IRS issued an advanced copy of the proposed regulations under section 409A, the topic of today's webcast. Indeed we have the honor of being one of the very first national programs on the new regulations. We intend to take full advantage of Dan Hogin's presence today, and so we have asked Dan to walk us through the new proposed regulations.

Along the way, to keep the focus sharp, Mark, Lois and Jennifer will pose questions to Dan, some that the audience has submitted and some they feel will be of general interest.The materials for today's webcast can be found on the initial web page for the webcast. If they are not there they will be there shortly. We had some technical difficulties earlier today. You will also find a copy of the proposed regulations along with Kilpatrick's detailed analysis of the rules. Rebroadcasts of the webcast will be available on the website later today and in about a week a transcript will be available. If you would like a transcript earlier please request those using the email address for questions.

With that, let me thank Dan Hogans for generously sharing his time with us today and without more Dan, please begin your discussion.

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

Thank you, thank you very much. Well, we're here to talk today about the proposed regulations under section 409A that were issued on Thursday of last week. Those proposed regulations follow on for notice 2005-1, which took a first cut at some definitional issues and transition relief in the implementation of section 409A, which was added to the internal revenue code under the American Jobs Creation Act of 2004. That provision has a statutory effective date of January 1st 2005 and so it is currently

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applicable provision as modified by the transition relief provided under the notice and it's further enhanced under the proposed regulations.

I'd like to note, that in connection with the issuance of notice 2005-1 we requested comments, we got a lot of very high quality feedback, well over 100 comment letters, many of which were detailed and numbered in the 10s of pages. In fact, the stack of comment letters on my desk is right around 2 feet high, and I think that's really reflected in the volume of issues we were able to address in the proposed regulations pursuant to the volume and quality of input that we got.

I'd also just like to make a brief comment about the folks who worked on this. I mean, Bill and Steve couldn't be here, but also Bob Meisner (ph), we were the core group who worked on this project and I think we all sort of worked very hard and did our best to get as far, as fast as we could. Steve, in particular was just instrumental in the volume and quality of this guidance so a special hat tip to Steve.

In that regard, as a starting matter with regard to transition issues, the proposed regulations and specifically the preamble to this proposed regulation extends the documentary compliance deadline under section 409A to December 31st 2006. Notice 2005-1 had originally set a compliance deadline of December 31st 2005 and after receiving a lot of comments and getting our arms around the full extend of the complexity of this provision the decision was made to extend the documentary compliance deadline to December 31st, 2006

That having been said, there are certain elements of relief that were included in notice 2006-1 which were not extended. The ability to cancel or terminate deferrals that are subject to 409A and get out of the rules without concern about constructive receipt issues is relief that expires on December 31st, 2005 that was not extended, so that really ought to be at the top of your list of action items to make a determination about what deferral programs or particular arrangements that you don't care to continue and if you wish to get those terminated you need to do that in 2005.

Now, we'll probably talk a little bit later about the ability to terminate plans on an ongoing basis and certainly you'll have the opportunity in connection with the documentary compliance deadline extension to revise time and form of payment elections and that also can be done through shortening of payment periods as long as its in a later year. so, you're not on the hook here for the long term necessarily, the extension of documentary compliance deadline also allows you to shorten payment periods, but it wont allow you to cancel and receive payment in 2006 of amounts that were scheduled for payments in later years.

I think the other kind of big, short-term action item is elections. The statutory rule for elections is that they be made prior to the year in which services are rendered to which the compensation deferred relates. That is the operative rule. We've provided a couple of additional rules in these proposed regs and we'll talk about those a little bit more, but you need to be making your, and reviewing your deferral election procedures to make sure that anything you need to do by the end of the year is done. Although you will get the opportunity in '06 to go back and revisit the actual time and manner of payment deferrals in conjunction with getting the documents sort of pulled together in terms of what you do and don't want to ultimately permit.

So, with that having been said and just to sort of recap briefly, '05 priorities are cancellations, elections and also -- I mean this is a little bit of an obscure issue but for those out there who have discounted options that are -- that become earn invested are (ph) after 1/1/05 and create a deferral issue under 409A, to the extend that you're going to adjust those in a way that is going to require the cancellation of a deferral, you want to make sure that you take care of that in 2005 as well.

So, with that I think we can sort of open it up to a couple of questions.

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Mark Wincek - *Kilpatrick Stockton - Partner, Benefit and Compensation Practice*

Thank you, this is Mark Wincek and I have the honor of the first question on me, before it do that - before I pose that question, just take a second to thank Dan for being available today and to compliment him and his team on what I think shows a lot of tremendous work. And, if other folks on the line would just be so kind as to mute their lines we'll jump in with some questions.

On the documentary compliance extension, one thing I think that's an important example of the kinds of helpful provisions that the proposed regulations contain and this one goes beyond what was in the notice, is that not only can you use the defendant documentary compliance time frame to amend your plan to comply with 409A, but now you can also amend the arrangement to exclude it from 409A.

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

That's right.

Mark Wincek - *Kilpatrick Stockton - Partner, Benefit and Compensation Practice*

Its important flexibility, but on the other hand there are some deadlines for documentary compliance that still remain in 2005. So for example, the participant elections to cancel participation of deferrals that you just had talked about, any plan amends that are related to implementing those cancellations are still due by 12/31/2005, isn't that right Dan?

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

That's a yes -- and that's a great point that's really key, that this cancellation relief is provided under Q&A 20A of notice 2005-1 and that clearly has documentary requirements associated with it. so, any plan amendment or election documentation does have to be executed by 12/31/05.

Mark Wincek - *Kilpatrick Stockton - Partner, Benefit and Compensation Practice*

And there are 2 more examples of transition items in the notice that have to be addressed by the end of 2005 and one of them is the special election, initial election right, it was provided to make election by March 15, 2005. And the other is the ability to terminate plans outright in 2005. And am I right, again Dan, that both of those require action for plan amendments in 2005?

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

That's right. So, for the going -- sort of looking back for a moment, those, that march 15 election relief to the extent that you need a plan amendment for that, that actually is also something that needs to be documented and nailed down by 12/31 of this year. And also any planned terminations under the Q&A 18 relief likewise have to be documented and completed by the end of the year.

I'd like to move on and just talk briefly about the contents of the proposed regulations, I'll make just a couple very brief comments about kind of what we've addressed and what we haven't addressed and then dive into the definitional issues which are a huge area here. The proposed regulations basically address three things. I mean transition, definitions which is kind of the scope of this provision and really I think in may respects is almost the most important part, whether you're in or out, since most people would prefer to be out.

And then operational requirements in terms of election timing and how the election timing rules work as well as payment timing and how multiple payments interact with each other and the prohibition against acceleration and any exceptions thereto.

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As a threshold matter and just kind of starting now with the definitions. The -- we've got a definition of deferred compensation here which as a threshold matter is dependant on a legally binding right to an amount in a later taxable year. and you don't have a legally binding right if that amount is basically at the mercy or the discretion of the service recipient. So what is commonly referred to as negative discretion. So to the extend they say, well, I'll pay you x dollars in year 3 but only if I feel like it. there's a serious question as to whether you've got a legally binding right to anything.

At the same time, we have adjusted a little bit the standard under which we evaluate negative discretion in moving from the notice, which had actually looked at the negative discretion standard from the 31/21 B2 regs and based on comments I think we tried to come up with a less nebulous and perhaps a little tighter standard that people could be a little more comfortable that in situations where they had negative discretion they could more easily demonstrate that it was real. So, that is a difference between the notice and the proposed regulations.

Also, the notice sort of expressed some ambivalence about what is probably the most important exception to these rules, which is the short term deferral rule, but that was picked up in full in the proposed regulations and sort of just to refresh here, basically takes the position that to the extent that amounts are paid concurrent with satisfaction of the earning condition to speak in practical terms for a moment, you don't have a deferral. So if it's paid when it's earned, no deferral.

As a technical matter this is expressed in terms of saying, well, if you have a promise to pay an amount in a future year, but that amount is subject to a substantial risk of forfeiture and when the substantial risk of forfeiture lapses the amounts paid in the same taxable year, or within 2 and a half months there after, then there's no deferral.

There is one kind of key adjustment here going from the notice to the, to the proposed regulations and that is that the standard under the notice required a writing that required payment of the short term deferral and it had to be in writing. There was a lot of concern about that that people could run afoul of this inadvertently by simply not having something in writing, even though they always pay on time and so on and so forth. So that's an issue that we tried to address. I think there are good reasons though why you might still want to have something in writing.

We've also got a special rule for separation pay arrangements, this is a big issue, especially with respect to the application of the 6 months rule -- excuse me the 6 month prohibition on payments on separation from service to key employees. I think there was a lot of concern that if all separation or if all severance pay arrangements were lumped into 409A it could really work a hardship, particularly on some of your lower down key employees upon a separation of service. So, the separation paid exception is designed to help deal with that because it applies to both key and non-key employees.

We've also provided some fairly detailed guidance on the extent to which cross border arrangements don't give rise to deferral of compensation. And this is kind of a key stepping stone to dealing with an issue that wasn't dealt with in this guidance and it will be dealt with later, which is the foreign, the offshore funding of deferred comp. And the offshore funding generally applies to deferrals of compensation, and so what these definitions do is they take certain things off the table in terms of saying that they don't provide for a deferral of compensation within the meaning of 409A.

And probably the biggest thing there is the -- there is a board based plan exception that in very rough terms tracks the US model treaty in terms of saying that, look, you have a foreign sponsored plan that's nevertheless treated, that's nevertheless, more or less, like a US qualified plan. Its non discriminatory and its board based and so on and so forth, that within specified parameters we're not going to treat that as non-qualified deferred compensation for purposed of section 409A. so that's a real important exclusion in cross border transactions.

In that regard, I think another thing to keep in mind is that where you're talking about funded arrangements and people are vested in these amounts, you're usually going to be picking them up under 402B anyway, which is another way that things would fall out under the short term deferral rule.

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We also provided a number of exceptions for, what I'll call, business-to-business type of situations. One of the more important ones is that anytime the service provider is an accrual basis tax payer there really cant be any 409A deferral and the reason for that is if you're an accrual basis tax payer, you're taking the compensation into income as its earned rather than being on a cash basis and taking into account when its paid or constructively paid.

So, that's a key distinction. Another exception is for service provides that provide services to multiple unrelated service recipients and in that situation we've provided some additional guidance about sort of what significant services to multiple unrelated service recipients are with a threshold of 70%, saying that as long as no one service recipient is getting more than 70% of the services, that -- and you've got multiple unrelated service recipients that that's pretty much good enough for that purpose. Obviously if you're a dedicated service provider to a service recipient that's kind of a horse of a different color.

And I also note that there's a special rule where the service provider is providing management or investment advisory services in some cases that we were concerned that in situations where there was really a demonstrable lack of independence between the service recipient and service provider that they not be treated as unrelated to this purpose and there are special rules provided with respect to that. I think probably can sort of try to go through a few questions on this and kind of expand some of that general discussion.

Lois Colbert - *Kilpatrick Stockton - Partner*

Okay, thank you Dan, you've already covered the material highlighted by the first question here, so I'll proceed to the second one which relates to the short term deferral exception. Assume that there is an arrangement that provides for payment, promptly following the lapse of the substantial risk of forfeiture, in other words, right after vesting, presumably this is exempt from 409A coverage pursuant to that short-term deferral exception. Now, what if vesting is accelerated on a discretionary basis, again with payment made promptly following vesting. Would that continue to be exempt under the short-term deferral rule?

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

Generally, yes. I mean, I think that we're always concerned and I think one of the reasons there was ambivalence in the notice on the short term deferral rule was that there was a general concern that, about sort of fake risk of forfeiture, that they'd say there was a risk of forfeiture when they really didn't mean it. But at the same time I think it was very important to maintain some business flexibility where you're going to pay an amount when you have -- when you've satisfied the earning condition, but if you want to change the earning condition you ought to be free to do that. I mean this is still America right? So -.

Lois Colbert - *Kilpatrick Stockton - Partner*

Okay, our next set of questions relate to the severance pay.

Jennifer Schumacher - *Kilpatrick Stockton - Partner*

And I'll pick up generally the separation pay rules contain an exception for plans that provide no more than 2 times an individual's annual compensation or no more than 2 times the 415 compliment.

Mark Wincek - *Kilpatrick Stockton - Partner, Benefit and Compensation Practice*

Jennifer just hold one second. I'm just going to again, ask anybody else who's on the line to please mute your phones, okay, thank you.

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Jennifer Schumacher - *Kilpatrick Stockton - Partner*

That 2 times comp exception applies to involuntary terminations in certain window periods, if an employee terminates under a good reason provision following a change of control and receives payments below the 2 times exception, are these payment subject to 409A because the employees are deemed to terminate voluntarily?

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

Well, I mean -- those payments would not necessarily be eligible for the exclusion. I mean I think in general the exception that's provided for separation pay is limited to involuntary separation and certain window programs and that really wouldn't countenance a good reason termination.

Now, an issue that isn't really addressed probably to most people's satisfaction frankly, is this issue of good reason termination. I think we've basically withheld judgment of when and whether good reason termination constitutes a substantial risk of forfeiture and the reason that's meaningful is because if it is a substantial risk of forfeiture, and you pay within the short-term deferral period, then it doesn't provide for a deferral of compensation. So I think, at this point under the proposed regs its still a facts and circumstances kind of determination as to whether a good reason termination provision constitutes a substantial risk of forfeiture but it think its reasonably clear that it doesn't fit within the exclusion for involuntary separation pay arrangements under the proposed reg.

Jennifer Schumacher - *Kilpatrick Stockton - Partner*

What if the change of control arrangement had a window where you could terminate following a change of control, and receive the severance benefits. Does that fit it under the window program?

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

Well, I think that -- then you just have to look at what the window program exception is and see whether you meet the requirements.

Jennifer Schumacher - *Kilpatrick Stockton - Partner*

So, conceivably it could, it wasn't, the windows weren't meant to be a very narrow, only applying to kind of a retirement plans special window that could conceivably extend to change of control situations?

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

I'd, like I say, I think you just have to see whether you can meet the requirements as established under the regulations.

Jennifer Schumacher - *Kilpatrick Stockton - Partner*

Okay, under that general 2 times comp exceptions a question was raised as to how compensation is defined. The proposed regs reference reg 1.415-1D2 but it appears that this is a typo, and we're presuming that 415-2 was meant rather than 415-1 if we read it as 415-2D2 -- 415-2D2 as in one 1D2, that would be compensation that takes into account provisions including certain comps, but not those provisions that exclude other comps like stock option gains. Can you elaborate a little bit on the definition?

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Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

Well it is -- it has come to my attention that the dash 1D2 is a nonsensical reference, so I'm imagining that the dash 2D2 is probably right and that's probably a typo that needs to be fixed.

Jennifer Schumacher - *Kilpatrick Stockton - Partner*

Still within separation pay, the aggregation rules provide that you combine all separation pay plans covering the same individual. So, presumably those rules would prevent taking a severance deal that exceeds the 2 times comp limit and splitting it up into 2 arrangements, one that would be under the 2 times and one that you comply with 409A, is that correct?

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

Well, I mean certainly you're not going to be able to use the limit more than once. I think it's a question we're still thinking about is whether you can have a separation pay arrangement that meets the 409A requirement, and also have a supplemental arrangement which maybe provides for a deferral of compensation but meets the 409A rules regarding payment of same.

So, I don't think, as it is, its -- I think its fairly clear that we've said that it's a plan that doesn't provide for more than that, so the particular excludable arrangement has to be limited to comp that is excludable under the terms of the reg, but it think it's a separate question as to whether you can also have a separate supplemental arrangement which would be viewed as separate for purposes of this rule.

Jennifer Schumacher - *Kilpatrick Stockton - Partner*

That's helpful. The next question is back to the definition of compensation for the 2 times limit, slightly different. The maximum results of the 41A17 limit, which generally is 210,000 for 2005. what if an employee is subject to a special 41A17 limit, like a grand fathered participant in a government plan, does that individual get the benefit of the higher 41A17 limit or was it meant to be the standard 41A17 limit?

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

Well, I think what we had in mind was the standard 41A17 limit, but then I think you just kind of have to look at the legality, the words on the page I think for now.

Mark Wincek - *Kilpatrick Stockton - Partner, Benefit and Compensation Practice*

Lets shift over to the area of post employment reimbursements and this is talked about in the guidance following separation pay. And there's a discussion about certain reimbursements that can be made within a period that extends until the second calendar year after employment termination and it says that if they're made within that period that they are not covered by 409A.

And one of the examples of what can be excluded is, what would be, income that is not includable in gross income for tax purposes or, compensation that's excludable in other words. I think most of us had assumed that excludable compensation would never be covered by 409A, but the implication from this rule is that that might not always be the case. Can you comment on that Dan?

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Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

Well, I think as a general matter it is fair to say that our operating principal was that 409A regulates deferred recognition of taxable income associated with compensation. I think a fundamental precursor to that is includable taxable income and so in general I think our sort of corollary principal has been that where amounts are excludable from income under all circumstances then they really cant give rise to a deferral except in the situation where you have a trade of a deferred amount for an excludable amount.

In other words you cant get out of 409A by relinquishing a right to 409A deferred comp in exchange for an excludable benefit like insured health benefits, post termination health benefits. But if the promise was only for excludable post termination health benefits from the beginning then there's really no manipulation of taxable income timing of recognition and it seems like 409A shouldn't apply, so I don't think any conclusion should be drawn from that.

Mark Wincek - *Kilpatrick Stockton - Partner, Benefit and Compensation Practice*

Okay, so that implication is not one that we should go crazy and make a lot out of. In connection with post employment medical benefits, one of the issues that arises is that oftentimes what's being provided is discriminatory if the plan is self insured under the rules of 105H, which bar discrimination for self-insured health plans. And that would bring conceivable into 409A if it goes on long enough, beyond this 2 calendar year period that's exempt, and health benefits are not timed in the way that 409A likes them to be, which is having fixed data payments, they get paid when somebody has an expense incurred when they submit the bill, so its kind of a problem.

To address that people have talked about shifting these arrangements over to employee pay all coverage. So where the employee in effect kind of pays the cobra cost of the coverage, the full premium is paid, that allows the benefit to get paid out to be tax free but coverage is taxable. There's no mention of those arrangements, 10483 arrangements in the regs, but as I think about them, they're just not compensatory. There's no compensation element that's being provided there. The employees buying something, not getting compensation. You have a reaction Dan?

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

Well, I think as long as everyone's conclusions are right, that you're paying the right amounts and so on and so forth and there isn't some disguised compensatory element that's not being reported that ought to be. So assuming, going with the generous assumption that all the underlying assumptions are correct, I would generally agree with you on that. But if the employee is paying a fair amount and that may be the way that a lot of these things get dealt with is that the employers just promise to pay x amount of dollars a year with the understand that those are what are, that sort of piece of money is going to be used to buy post termination health coverage at a fair value price.

Mark Wincek - *Kilpatrick Stockton - Partner, Benefit and Compensation Practice*

To -- I guess be perfectly safe, it would stay within the time period, which is 2 calendar years after the employment termination and limit our medical reimbursements to that period. The rule requires that however we have to not only have the employee incur the expense during that period, we also have to get the payment out to the employee during that period. So, we need some, I guess some, have the rules kind of work in a way that takes into account that its not a claims incurred basis, its actually a claims paid basis.

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Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

Well, and for health benefits, I mean we were trying to kind of go with a one size fits all consistency approach here but I mean this is one area where we might want to revisit this issue and if we can come up with reasonable language on claims incurred that we're comfortable using, that that actually might be a more workable standard for people and make more sense.

Mark Wincek - *Kilpatrick Stockton - Partner, Benefit and Compensation Practice*

Very nice to hear that, okay. Talk about SARs and stock options for us.

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

Sure. You know in addition to the short term deferral rule probably -- and the extension of the documentary compliance deadline, probably the other enormous hot button issue that really had people worked up was the treatment of equity compensation, specifically stock options and stock appreciation rights under section 409A.

Congress clearly intended to carve our what I sort of commonly refer to plain milistock (ph) options and they had a delegation or a direction to that effect in the legislative history, saying we believe that stock options that are issued at an exercised price can never be below fair market value, that generate income includable under section 83 on exercise and don't have an additional deferral feature, do not provide for deferral of compensation within the meaning of section 409A.

The notice kind of took an intermediate position with respect to stock appreciation rights. I think recognizing that at least for publicly held companies with easy to value stock there was a comfort level with treating economically equivalent stock settled rights on public company stock the same as excludable options on that same stock. And then there was transition relief provided for stock appreciation rights, plans that were in effect when the statute was sort of coming through the committee and then enacted.

The proposed regulations sort of go a good deal further and essentially carve out options and stock appreciation rights that are economically equivalent on the same terms. So it no longer matters whether you are a public or private company, you can have excludable rights. Those stock appreciation rights can be cash or stock settled. What matters is that the exercise price can never be less than fair market value, that you recognize the impending income on exercise and that there are no additional deferral feature. Of course the fly in the ointment, with respect to non-public companies, is evaluation.

So we spent quite a lot of effort trying to come up with valuation rules that would be a little more detailed and a little more user friendly then really we've been able to come up with in the past. The starting point is we started with the valuations standards from the old estate and gift tax regulations, but recognizing that was not going to give people the level of comfort that they preferred, we also added three essentially safe harbor valuation methods.

The first mirroring the independent appraisal rules that applied to employee stock ownership plans with non-public stock. We also put in a safe harbor for sort of formula valuation methods that qualify as fair value under the section 83 regulations, with the additional condition that that valuation method be applicable for both compensatory and non-compensatory transactions in the stock between the service recipient and the service provide or stockholders.

And then we also provided a third safe harbor for start up companies with non-public stock and liquid stock. With the idea being that if you have an option right on stock and there is no call right, other than a right of first refusal with respect to the stock that you would get on the exercise of that right and as long as the valuation is undertaken by a qualified person, although not necessarily an outsider meeting the independent appraiser requirement and you have a written report that you can qualify for sort of heightened respect for your valuation approach. I think this is probably going to require start-up companies.

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By start-up I mean with a trigger business that is less than 10 years old, this is going to require that they probably do a little more homework then they were in the past but it still doesn't require them to try to go out and find an independent appraiser. Which especially in the technology industry can be kind of difficult because people are dealing with technologies that not enough people know about to find a qualified appraiser.

I think there was a big concern about being able to find qualified people about the value thing. So under that approach you can use insiders for purposes of valuation. So with that I will sort of open it up to a few more clarifying questions with respect to the equity compensation inclusion.

Jennifer Schumacher - *Kilpatrick Stockton - Partner*

Thanks and one additional change is the fact that preferred stock was fairly invented and not service recipient stock under these new regulations.

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

Yes, I'm sorry that's a great point. And I forgot to mention that. It is a very important point. One of the keys about excludable options or rights here, is that it is only excludable to the extent it is on service recipient stock and that is a defined term. It does not include preferred stock. If you have an aggregated group, under the aggregation rules that are included, if they are a public company shares then the public company shares are the service recipient stock.

If none then it is the class of common stock that has the largest value of service recipient. So the idea here is to capture common stock, enterprise value, there is a real concern about using sort of designer securities or preferred stock that starts to look like debt and gives very predictable results and could even sort of mirror deferred comp arrangements. But to narrow this exception is what congress intended. Which is to preserve the incentive for participation in real enterprise value appreciation in U.S. companies.

Jennifer Schumacher - *Kilpatrick Stockton - Partner*

I have several clients who do use preferred stock because the common stock is worthless and there is so many layers of preferred stock already. But preferred stock is the only way to give employees some type of option value. Have you had a number of comments on the preferred stock? Do you see any changes there?

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

We have had a few, honestly not a lot. One thing you may want to do is switch to using RSUs. I think there are other ways to deal with this issue. But the options on preferred shares are -- I wouldn't expect that to change. I don't want to hold out a whole lot of hope on that one.

Jennifer Schumacher - *Kilpatrick Stockton - Partner*

Discount stock options are subject to 409A, so they would need to include a payment exercise date. Is it okay to draft a discount stock option to require X5 (ph) during a stated year? If the options in the money and provide that if it is not in the money that it will terminate at the end of the year?

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Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

Sure. I mean I think that would be a 498 deferral arrangement that meets the fixed time and manner of payment requirement, so that should work yes.

Jennifer Schumacher - *Kilpatrick Stockton - Partner*

Now switching to extending option exercise periods. The proposed regs say that if you extend the option exercise period it is not treated as a modification new brand but the option is subject to 409A from the date of grant. If instead of extending the exercise period the company just lets that option expire and then grants a new option with the exercise price equal to fair market value on the date of grant, is that okay?

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

Sure. I think what is important to understand is what is being regulated here. Clearly congress said no additional deferral feature on an excludable stock option. So, you cannot get around that rule by adding it later. That is why we were going to treat the addition of a deferral feature, including an extension of recognition to a later taxable year, because what's that except a deferral.

We had a retro-active effect so that if you add a deferral feature it is going to be treated as though you had it from the beginning. So that is something to be avoided. At the same time one thing that this doesn't express a view on is option re-pricing. If you have an option that is out of the money and you cancel it and grant a new one, we didn't view 409A as a mandate to sort of have any say about that.

So as long as your new option is granted at fair market value and otherwise meets the requirements to be excluded from 409A, that's fine. If you did this as a matter of habit so that it looked like you actually had a variable exercise pricing option that might be sort of a horse of a different color. But certainly one off kind of option re-pricing doesn't cause an obvious problem under 409A.

Jennifer Schumacher - *Kilpatrick Stockton - Partner*

Option plans often contain bad boy (ph) provisions that allow the company to buy back the stock at the price the employee paid upon exercise, which is lower then the current fair market value. Such a provision appears to create stock that are subject to a call right based on the measure other than fair market value which would pull it outside of the definition of stock of the service recipient. Is that intended?

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

I think we will be willing to entertain comments on this. Certainly if it is going to be bought back in less than fair value, or an amount no more than fair value, then I think that there is probably a language tweak that we can do to fix that. So that is definitely a helpful comment.

Jennifer Schumacher - *Kilpatrick Stockton - Partner*

Again assuming we have an option that is subject to 409A like an option on preferred stock or just (inaudible-background noise) and we want to rely on the short term referral rule so that the agreement drafted to require that the option exercised within two and half months at the end of the year that it is backed. Is there a problem because the employee has the ability to choose which year to exercise the option? Either the year in which it vests or the following two and half months?

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Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

I'm sorry, I was kind of distracted by the person sneezing on the phone there.

Jennifer Schumacher - *Kilpatrick Stockton - Partner*

Yes, there --

Michael Wyatt - *WellPoint Inc. - Vice President and Deputy General Council and*

Let me just ask any one that is on the line besides us to just please mute your phone, thank you.

Jennifer Schumacher - *Kilpatrick Stockton - Partner*

The 2005-1 seems clear that you couldn't give an individual a choice between two tax years. But the basic short term deferral rule with options you could draft then to say you have to exercise options or SAR within two and half months at the end of the year in which it's vests. Is that create a problem because you now have given then a choice between which tax year?

Mark Wincek - *Kilpatrick Stockton - Partner, Benefit and Compensation Practice*

The jest of this really Dan is looking at the notice it seems very clear that she could not give people a choice between two and two and half months after the year or during the year itself. It had to be one or the other but not both and both regulations don't seem to make that as clear having basically dropped that as part of the shift towards requiring less to be spelled out on the short term deferral rules?

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

I think that is something we have to think about some more, I'm not sure if that was an intentional change.

Mark Wincek - *Kilpatrick Stockton - Partner, Benefit and Compensation Practice*

Okay. Then let's consider an option that allows the employee to exercise it while the employee remains employed. That if the employee has had some sort of leave of absence and it is kind of a convenience leave of absence, that the expectation is not -- there's not going to be a lot of services provided. And let's even assume it is below the 20% below the prior services level what is extending the option in that way, what is the effect under 409A if the ordinary extension would cause that to fall within the 409A coverage. If it is extended indirectly by a lead grant but more overtly how does that get analyzed?

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

I think by analogy we have thresholds for when someone deemed is separated from service. Generally said if you are at a level of less than 20% services that is generally deemed to be a separation from services if you are over 50, if you are in between it is kind of gray. We do have special rules for leaves where you have a legal enforceable employment right, there clearly you would be treated as not separated. But in general, I think you have to be real wary of trying to use a leave to extend an option exercise period because that generally -- you would want to first of all analyze it under our separation from service framework and secondly to the extent that you are pushing the exercise to a later taxable year that has a high risk of being treated as an additional deferral feature.

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Mark Wincek - *Kilpatrick Stockton - Partner, Benefit and Compensation Practice*

The definition of service recipient stock is now more flexible in terms of the affiliation that is required between one entity and an sub-corporate grouping in another. The notice required 80% and proposed regulations allow that to be dropped to 50% and in fact given option in appropriate circumstances when the business justification for it to go as low as 20%. If I'm drafting my plans it seems I should probably just go ahead automatically put in, that will be 50% except where a justification exists it will be 20%, make it automatic as well as possible. I don't see any harm in doing that.

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

I think we're concerned about the framing of the public company stock issue here. The way the right reads, if you have an aggregated group for this purpose and one of the members of the group has publicly traded stock that's your service recipient stock. So, it may be that you don't want to have an extension of your group because you want to keep the right on one of these kind of non-majority subsidiaries to use the subsidiary stock as service recipient stock for this purpose.

But the same time we are trying to accommodate joint venture type of arrangements where you have multiple big company partners and they want to take care of their legacy employees. So we didn't wan to create a 409A problem, where there was a good business reason for service recipient companies to be issuing equity rights to employees of joint ventures.

Mark Wincek - *Kilpatrick Stockton - Partner, Benefit and Compensation Practice*

Okay. One of the issues that has been talked about a fair amount, between when notices came out and the proposed regulations, is what the impact will be of giving employees of a choice of two different awards. And imagine if you will, I have one award like an option at market value which is normally exempt from 409A, and I pair that with let's say a restricted (ph) stock unit that embodies a deferral feature, and so will not be exempt from 409A.

There's an example in the regulation that talks about a chart between bonus and restricted stock and that implies that you look at those two as a single arrangement and rises or falls as being covered by 409A as a whole. But is that really true in a case like I just described, or is it possible that I make my choice at the right time that I could have my option be exempt from 409A as a market value option, even though my restricted stock unit might in fact be covered by 409A?

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

Yes, I think the idea wasn't to say that by offering a choice the option automatically provides for a deferral of compensation in that situation. But merely to emphasis that if you are giving people a choice and one or more of the menu items is an item that constitutes the 409A deferral of compensation you got to make a choice in observance of the applicable rules for deferral elections that apply to 409A deferral. And, you know, I suppose you can do that either by election and even have a default rule. So once the choice is made if what you have chosen is not by definition a deferral of compensation the offering of the choice is not going to change that.

Michael Wyatt - *WellPoint Inc. - Vice President and Deputy General Council and*

Okay. Can we go back and discuss elections and payments Dan?

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Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

Sure. You know I'll just try to do this just briefly. Basically there was relief under the notices we mention a little bit earlier that gave people until March 15 of this year to make election the proposed reg doesn't include any sort of broad-based relief of that nature what they do include is a couple of additional deferral constructs for initial deferral that are sort viewed toward multiyear and sort of ad hoc awards that occur mid year.

So you've got your basically operable rule that says you've got to elect before the services are rendered to which the compensation relates and in addition now you have a rule that says well if you've got compensation that is subject to a multiyear vesting period you can apply the rule that looks very much like a subsequent deferral rule if you elect at least one year before it vests and you agree to 5-year additional deferral that can be a good initial deferral election.

There is also a rule for sort of certain awards that are subject to a service period that are greater than a year where you can elect within the first 30 days after the award date to defer payment. Now that is contingent on a requirement that at least 12 months of services must be required after the date that you make the election, so you can sort of think of it as a 13 month rule, and I think it is best illustrated, you know, under the following example.

If I am awarded an RSU grant the if I render 2 more years of services will vest than I can elect within 30 days of receiving that award and I'm good because I've still got to render, you know, another 23 months of services to earn the award so 23 is greater than 12 so I am all set. In addition though, I can elect at any time before the end of the year one and as long as I push off 5 years I can also use that sort of subsequent deferral rule to make an initial election. So those are the two big conditions.

We also added a proposal for defining performance-based compensation. Putting some flesh on the bones of the 6 month performance compensation rule. That is a little tighter than that the performance-based bonus exception that's in the notice you can continue to use the notice. I mean those are proposed regs and you can rely on them if you wish but they are not binding you may continue to rely on the notice so the notice has a perhaps a slightly you know a rule that people my view as more beneficial and you are able to choose to use that rule.

And then I guess the other moving away from initial deferral elections the one sort of general comment I'd like to make about a subsequent deferral rule is that, you know, it's probably the most, sort of, intellectually complicated and difficult portion of this guidance package. Which I mean the rest of it is largely not brain surgery it's just a matter of volume but this part is a little bit of a brain teaser, you know, what were striving for was sort of a parity equity paradigm but it ends up being a little bit complicated and hopefully in the and I think it's worth it. And the general idea here is to two fold.

First if you have a life annuity or installment payments that you basically designate to treat like an annuity than the annuity starting date is the date that you measure from for the purpose of your 5 year rule. It is sort of treated like one payment because we thought, hey, people usually think of those things as one form of payment so one payment and you measure; you only have to push off from 5 years when that annuity or payment stream would have started.

In the alternative you can treat individual payments or installment payments that you designate for treatment as individual payments as just that. You can move them separately; you can just put every share exactly where you want it subject to the one year 5-year rule. So you can either manage these things as a payment stream or as individual payments although you're kind of locked into one or the other based on what you're plan document says.

Now the important thing about this distinction is what it does is it treats a change from a lump sum to life annuity or vice versa basically the same. So if I started out and I elected a life annuity and I said no I don't want a life annuity I want a lump sum, I can get a lump sum it's just got to be 5 years after my life annuity would have started. Conversely, an I think it was always pretty clear under the statute that you can do this, you can start out with a lump sum and say I'd like to elect to get a life annuity and have that start 5 years after you would have gotten the lump some and that's okay.

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So, we've set this up so you can go in either direction. The other key point is with respect to what the 5-year push off applies to and here we have kind of subdivided the payments into categories based on what the containment trigger is. So t is a concrete example the 5-year push not only applies to that which you change. So, let's say I had a payment scheduled at age 55 and my provision also says at age 55 I get 10 annual installments it also says I get a lump sum if there is a at change of control, in any event.

And so I say you know I don't want an installment at age 55 I want a lump sum at age 60. Fine, you know, as long as I elect while I'm, at least at least one year before 55 I can push off to age 60 and get a lump sum and I'm good. And the question is, how does that affect my change of control payments? Does that mean that I am subject to change of control so that I can't get the money until I turn 60? And the answer to that is no.

If I didn't change anything about the payment on change of control the 5-year push off does not apply to that change of control payment and I can still get that lump sum when I change of control you are only subject to 5 years on that which you change. So I think that was kind of a key distinction here, you know, which frankly I think the 5 year, subsequent deferral rule wouldn't have been much use to anybody if you didn't take that approach so that was kind of a key distinction. So with that I think we may try to eliminate this a bit further with some penetrating questions.

Jennifer Schumacher - *Kilpatrick Stockton - Partner*

Okay. The first penetrating question relates to another special rule that you've added in the regulations relating to crossover pay periods and I'd just like to flush it out with this question. Suppose you have a pay period that runs from December 24, 05' through to January 6, '06; if a person makes salary deferral elections each year which year's salary deferral elections would apply to that crossover pay period?

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

Well, in general we came up with a rule that says the crossover pay period is treated as, you know, the services are treated as rendered in the, it was in the year you are paid. Okay. But basically what we did there was we didn't want you to subdivided pay periods based on when the services were rendered you can actually do it either way based on your election but the default is the year your paid.

Jennifer Schumacher - *Kilpatrick Stockton - Partner*

Okay. So the default would be that the second years election would apply to that payment stream but you could in your provide for the prior years election to apply. Am I in correct in reading the reg to require that the crossover period must include December 31st so for example if you had a pay period that ran from December 21 through December 28 but the payday occurred in earlier January, early January that would not qualify for the special rule?

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

That's right. And that is the service period rule.

Jennifer Schumacher - *Kilpatrick Stockton - Partner*

Okay. That's helpful. Is there any chance of us getting a special rule like that in connection with the 30-day election period for a person who becomes newly eligible for a plan?

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Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

Generally, I would say no. I think the considerations there are a little different, you know, it's more election volitional; I think there is more potential for manipulation. I recognize that's paranoia but it's a different set of circumstances.

Jennifer Schumacher - *Kilpatrick Stockton - Partner*

Okay. Moving over to another of the special rules, the regulation now provide that in specifying the time of payment rather than specifying the particular day it is permissible to specify just a calendar year in which a payment will be made. So you can say a payment will be made anytime in year 2006, and that will meet the specified time requirement. However, if you take that option and draft your plan in that manner for purposes of the subsequent deferral rule you have to operate off of January 1 of that calendar year. The question is instead of using a specified year could you specify a month in which payment would be made and use the first day of that month as your deemed payment date for purposes of subsequent deferral election?

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

I can't see a reason why you couldn't. I mean the rule doesn't specifically permit that, I mean, I think we'd just view that as being designated the first day of that months. You know that is sort of a nuance here to be aware of with respect to timing of payments if you an elect a year and for purposes of the one year 5-year subsequent deferral rule you'd be treated as having designated January 1st and you can pay anywhere after January 1st and its all good.

If you do specify a date within a year then generally you have to pay on or after that date but within the year. You do have like a two and a half month grace period for dates that are late in the year but generally once you specify a date within the year you cannot accelerate in front of that date within that same year.

So, it is important to recognize that, you designate January 1, that's fine you can uses the whole year but if you specify a date you can only on or after that date during that year with this little two and a half month grace period, so. The way this grace period works is if the end of the year occurs less than two and a half months after your specified date you still get two and months after the specified date to pay the money. So for December 31st that would be in March 15th.

Jennifer Schumacher - *Kilpatrick Stockton - Partner*

Okay.

Michael Wyatt - *WellPoint Inc. - Vice President and Deputy General Council and*

Let me talk a bit about the example that you gave where somebody has one payment date which is based on a time and accelerates based on change of control lets take a case where the first payment is let's say 3 years after completion of 5 years service. So vesting at three years and then three years after that payment occurs but earlier payment on a change in control. It doesn't matter in this case that the change in control requirement is not a 409A change in control as long as it would constitute a substantial risk of forfeiture event , isn't that correct?

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

Yes. Generally, yes we do permit that specified time of schedule to be based on when a substantial risk of forfeiture lapses assuming that this designated change of control event constitutes a substantial risk of forfeiture it really wouldn't matter that your change of control definition doesn't lineup with that required for payments of deferred comp under 409A.

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Michael Wyatt - *WellPoint Inc. - Vice President and Deputy General Council and*

Okay. So lets assume that I have this same kind of arrangement 3 years of service for vesting then paid 3 years later, but I didn't put in my change of control acceleration from the outset. And so now I'm looking at this and saying incident well gee, I'd like to add that and I use the subsequent election rule, the redeferral rules to get that in. than assume that I did it enough in advance, lets say the vesting date or something, one year in advance of that, but now called month kind of issue, and its hooked on the 5 years aspect of this rule.

Would it be okay if I said okay I'll get paid out on change of control, but I'll now push the time frame that is tied to the vesting date out a little bit, and I'll say that now is 8 years after vesting and I'm in turn changing the change in control will be recognized for 5 years after. Does that work?

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

Well, I think that as long as you push now 3 plus 5 to 8, I think you are clearly okay. One of the things that is not entirely clear is the way that we drafted this is whether change in control plus 5 is okay so one of the things that we are sort of -

Michael Wyatt - *WellPoint Inc. - Vice President and Deputy General Council and*

And that was my next question.

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

Yes, what if you are scheduled payment date is 20 years out and you add change in control, can it just be change of control plus 5, even if that date is before the 20 or is it change of control you know, as long as it's at least 25 years out and that's something I think we need to clarify because I don't think it is clear under the rules.

Michael Wyatt - *WellPoint Inc. - Vice President and Deputy General Council and*

I think there is some language at least in the preamble that might cause a reader to think that just having it be change of control as long as that change of control is no sooner than 5 years -- I'm sorry the later change of control or if later 5 years from when you add that. Do you think that would be acceptable? But what I think you're telling us is that may not be fully intended.

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

Well I think, I don't think it is super clear from, there is some indication from the preamble that the reg itself is not, I think, crystal clear on that subject. So that's something obviously we will need to clarify.

Michael Wyatt - *WellPoint Inc. - Vice President and Deputy General Council and*

Let's get into planned termination and other issues, Dan if we could.

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Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

Sure. And this really kind of gets into the application of the anti-acceleration rule. Generally, you know, once you're in for a penny, in for a pound. You know, once you elect and defer you're locked down except as your permitted to change there isn't a general anti-acceleration rule but we had delegation or reg authority to provide exceptions to that.

We did provide some exceptions for planned terminations under specified circumstances upon complete liquidation, under the supervision of the Bankruptcy Court, and also we did provide for voluntary termination provision, although it's been described to me as not to be really attractive, which is okay. The idea here was if you really want to get out of the deferred comp business you can, but you need to be sure about that.

So you're required to terminate all plans by the same type, and that means for all participants, you have, you cannot pay any amounts on planned termination for 12 months, you have to pay all amounts on account of planned termination within 24 months, and you cannot adopt a plan of that same type for 5-years. So, you really need to be sure that if you're terminating you're non-account balance plans you want to terminate all of them and that you don't want to have any more for 5 years.

The 12-month delay requirements is just to keep people from raiding the piggy bank and the 24 month requirement is to keep from turning this into a cute way to have a subsequent deferral election. And so that's why those restrictions are there. You know, I think there are also in this context would be acceleration rules and this also kind of bleeds over into elections also is guidance we provide on dealing with linkages between nonqualified arrangements and qualified arrangements.

It's pretty common to have wraparound arrangements for 401(k) plans sometimes called spillovers where you have amounts that can't stay in the K plan and go to nonqualified plans and you accumulate money in the nonqualified plans until you figure out what you can put in the K plan and leaving aside any DOL issues with one or both of those structures.

But you know there are people who do them in either of those ways and so we try to deal with that by basically kind of having a deminimus rule that says look if you have spillover or cancellation of deferrals that sort of a corresponding effect from change in a 401K election then as long as that spillover effect is less than the 401G limit than no harm no foul we'll ignore it basically for 409A purposes.

Likewise for the extend that you have a match in the nonqualified plan that's effected under the, by your 401(k) contribution for better or for worse, change in that is not, you know, basically the corresponding effect in the nonqualified plan doesn't cause a concern for 409A purposes as long as that corresponding effect doesn't exceed the 402G limit in any given year.

Also with respect to defined benefit type plans it's very common were you've got, you know, changes in benefit formulas, or changes at IRS limits that your actually going to have a benefit shift back and forth between the qualified and nonqualified plans and I think we made fairly clear that those kinds of benefit shifts don't cause any kind of late election or accelerated payment issues and so, it's kind of, in that regard I think there should be, you know, some reasonable comfort level on some of the interrelations between the qualified and the nonqualified plans. Now one thing I want to highlight is that a lot of plans have linked elections, and there is some relief provided for linked elections through '06, but as we are going to talk about a little further here in a minute that's probably as far as it goes.

So with that we can maybe move on to more questions.

Unidentified Audience Member

Thanks Dan. One thing you mentioned on the rap (ph) plan was that you get the (inaudible) at 4 matches and for elective deferral the reg could be read as only allowing one of those. Can you just clarify that you do get that for each of the elected deferrals and the match?

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Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

Yes. Those limits are applied separately. So, if you got a spill over effect that just an employee deferral, that's got its own 402G flex limit, and then if there is also a match, that has a separate 402G flex limit. So, I guess in theory you could have a $28,000 - but they are applied 14 and 14. Separate for each one.

Unidentified Audience Member

Great.

Michael Wyatt - *WellPoint Inc. - Vice President and Deputy General Council and*

I think a lot of folks as you say, had linked elections in the past between their qualified plan and their non qualified plan. And part of the reason why I didn't like that is, it simplified benefit calculation, just sort of forced the employee to take their non-qualified money at the exact same time you compute on benefit, you figure out with the qualified plan portion of that is and the rest is a non-qualified. So, there is no conversion from different forms and all that extra complexity.

For people that only have plans that offer (inaudible) annuities - there may be some situations I think where they can try to stick with the idea of keeping the employee where the qualified plan election is going to control the non-qualified plan election, and therefore you can simplify their life in terms of the calculation benefits.

And the example I was going to mention is the non-qualified plan provides that it will pay, as of the 1st of the month after retirement, in the event that the employee has made a qualified plan annuity election that is binding as of that date, that election will then be applied to the non-qualified plan by the terms of the non-qualified plan. To get the employee on the same page of the both qualified and non-qualified plan. Any kind of reactions to that Dan?

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

Well, I'm not saying that there are not real good reasons why you might want to have them linked and in a perfect world that might be how it works. Certainly there is relief provided for choices between actuarially equivalent life annuities. So - where the only choices you have under a plan are actuarially equivalent life annuity forms including joint and survivor options. Then it wouldn't be a violation of the 409A election rules to make a late choice between those two.

So it is conceivable that if you get comfortable with the other tax issues, that a late election on that type of limited selection would be fine. But as soon as you offer shorter installment payments or lump sums, it's a completely different analysis. And in that case, after '06 those choices, I think, really have to be deranked.

And, I don't want to minimize -- that's complicated stuff that it creates, I think, some major plan design issues because a lot of time people want to take their non-qualified benefits up front, but they don't want to take their qualified plan benefits until later, and so you end up with true-up issues and all kinds of stuff, because what they're really entitled to under the non-qualified plan is a function of what they get under the qualified plan. So, I appreciate that having those things linked is a great business convenience but it's generally inconsistent with what 409A requires.

Mark Wincek - *Kilpatrick Stockton - Partner, Benefit and Compensation Practice*

Some folks, I think, are finding themselves in a position where they are, basically, facing difficulties and challenges in terms of administration that they never contemplated having to face. Getting back to your point about the other laws and other legal

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principles that apply, obviously 409A is a supplement to constructive (inaudible) income tax principles that govern situations where people have control, I think with non-qualified deferred comp.

And, that, I think, also ties into the situation where there's a link between a qualified plan and an unqualified plan. There's a discussion in the preamble that says that this linkage ability continues during 2006 as part of the transition relief under 409A, but it cautions the reader that they need to be aware that other tax principles have to be navigated and that basically make sure that you do.

And, that kind of poses the questions that, I think, a lot of sponsors have traditionally thought that the fact that the employee has to take the qualified benefit in the same form as the non-qualified benefit, it is, in effect, a substantial restriction on the election of the non-qualified benefit and, traditionally, substantial restrictions have been held to be enough to avoid that constructive receipt (ph). Do you want to comment on that one Dan?

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

Well, I think it ultimately ends up being a factual determination. I don't think we've ever, sort of, acquiesced to that idea, or I don't think the government ever has. And, certainly, in some cases, the non-qualified benefit simply dwarfs the qualified benefit, and qualified benefit really isn't a significant part of the overall benefit. In those situations, I think the substantial limitation restriction argument is weakened. In other situations, it's more difficult to say. Maybe it is, maybe it isn't.

Mark Wincek - *Kilpatrick Stockton - Partner, Benefit and Compensation Practice*

Thanks Dan.

Michael Wyatt - *WellPoint Inc. - Vice President and Deputy General Council and*

Hello Mark. It's Michael. I just wanted to let you know we've got 10 minutes left.

Mark Wincek - *Kilpatrick Stockton - Partner, Benefit and Compensation Practice*

Great. I think we're on track.

Michael Wyatt - *WellPoint Inc. - Vice President and Deputy General Council and*

Good deal.

Lois Colbert - *Kilpatrick Stockton - Partner*

Dan, would you lead us to a short discussion of the grandfathering rule and the material modification definition.

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

Sure. Essentially, and this is kind of a key point here in terms of our little shift from the notice to the proposed regs, the statute and legislative history grandfather amounts that were earned invested at 12/31/04. So, to the extent that you had a deferred comp promise that was invested at 12/31/04, and you don't have to render additional services, or it's not contingent on events on or after 1/1/05, then that's grandfathered and then reasonable earnings track the grandfathered amounts and stay with the grandfather.

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You keep the rights that you had under the terms of the arrangement as in effect on October 3, 2004, so you kind of have a parallel old law universe for the grandfathered benefits. One notable item here is that with respect to the measurement of amount of grandfathered benefit under the defined benefit plan, the proposed regs do take a slightly more liberal approach.

The notice took a fairly hard line present value of your earliest payable benefit type of approach and the proposed regs allow a little more of a wait and see type of approach that say, well, it's the most valuable benefit that you ultimately become entitled to. Without regard to services or events occurring or rendered on or after 1/1/05, and taking into account only the terms of the plan as in effect as of October 3, 2004. So, it's a little more flexible a standard that we adopted in response to comments from the actuarial community.

Mark Wincek - *Kilpatrick Stockton - Partner, Benefit and Compensation Practice*

Just to clarify, you say that service after that present count and events won't count to allow you to get a most valuable benefit rate, let's say flexidize (ph) kind of benefit, becomes available later, but as I understand it, just aging into something you already have enough service for, that's not a problem. That can be grandfathered. Is that correct?

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

Well, I think it depends on what you mean. Let me give an example. I think one of the main things we were thinking about, and maybe this is what you mean by aging into, let's say that you have rendered all the service necessary to be entitled to a subsidized benefit at age 62, but you've got an array of benefits you can choose from this array from age 55 on, but you wait until 62 you get a little bit of a subsidy, and so you do have benefits on offer that are of varying values.

I think this rule is intended to say that if you wait until 62 to claim the benefit, and therefore get a subsidized benefit, that that portion of the benefit that relates to services that were rendered on or before 12/31/04, that earned invested portion of that subsidized benefit is grandfathered. So, if that's what you mean by aging in, yes, that's right.

Mark Wincek - *Kilpatrick Stockton - Partner, Benefit and Compensation Practice*

Good.

Lois Colbert - *Kilpatrick Stockton - Partner*

Okay Dan, if I can ask just a few questions that get at the definition of what earned invested means for purposes of the grandfathering rule?

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

Yes.

Lois Colbert - *Kilpatrick Stockton - Partner*

For example, let's say you have a pre-2005 arrangement that provides benefits upon occurrence to the change of control, and let's assume the change control has not happened prior to 2005. I assume that that arrangement does not grandfather and would be subject to 409A? Is that correct?

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Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

Yes.

Lois Colbert - *Kilpatrick Stockton - Partner*

Okay. What I if you have a pre-'05 severance agreement that ties benefits to an involuntary termination? The guidance suggests that, or makes pretty clear, that conditioning benefits on an involuntary termination would constitute a substantial risk of forfeiture. So, does that mean that this severance agreement is not earned invested pre-'05 such that it's subject to the new rules?

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

Yes. But it may be a short-term deferral.

Lois Colbert - *Kilpatrick Stockton - Partner*

Right. Now what if the agreement also said that benefits will be provided if you terminate voluntarily for "good reason," which is a pretty common provision in severance agreement? Does that change the result?

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

Not really. And, this is kind of one of those weird ones where you might be treated as vested for 409A purposes, but not earned invested as for purposes of the grandfather rules. The 409 vesting provision takes a very inclusive approach and treats you as vested in amounts that you may very well forfeit in some circumstances whereas the earned invested standard is really aimed at, well if you quite on 12/31/04, what would you get. What would you be entitled to, and so it's a slightly different standard.

Lois Colbert - *Kilpatrick Stockton - Partner*

Okay.

Mark Wincek - *Kilpatrick Stockton - Partner, Benefit and Compensation Practice*

And just to go back to your comment about what would be the case in terms of qualification on the short term deferral rule and the example that Lois gave us where it wasn't earned invested at '05, or severance wasn't because the person had not at that point had involuntary termination. Severance is conditional, involuntary termination, so it's not grandfathered, but, as you say, if we take involuntary termination as being a vesting date, then as long as payments are made off of that within a certain period of time, a short period of time, not more than two and a half months in the following year, that can be then under a short-term deferral.

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

Right. It would be an arrangement that doesn't provide for deferral compensation. Just to kind of take this one level of complexity further, if you had one of these good reason arrangements before 12/31/04, and the good reason condition occurred before 12/31/04, then you might very well be earned invested at that time if you could quit on December 31 and get paid because you had good reason, that's another set of facts.

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Lois Colbert - *Kilpatrick Stockton - Partner*

Yes.

Mark Wincek - *Kilpatrick Stockton - Partner, Benefit and Compensation Practice*

One of the big areas of concern for folks is in connection with, perhaps, accident (ph) internal modification. And, let's assume the case where an employer has an arrangement under which employees entitled to receive deferred comp and the payments are supposed to begin in installments begin in December 2005 and there is simply an administrative cross up and the payments are instead begun a year early, December 2004, what is this employer's situation?

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

Well, you might be able to deal with this by using the cancellation relief for the amounts that were accelerated, because, I think, you probably have a material modification because of your action. But, you might be able to fix it in terms of avoiding penalties by executing a cancellation for the amounts that were actually paid, and then any sort of conforming election necessary to reset your going-forward payment schedule under the Q&A 19C-Relief. So, you may be able to use 20A19C in this situation to, at least, avoid penalty.

Mark Wincek - *Kilpatrick Stockton - Partner, Benefit and Compensation Practice*

So, would your take be that because of the change that the entire arrangement would fall under 409A, and so, the modification causes the need to cancel the cancellation on the part that was paid too soon, and then you'd want to reset the timing on the remainder of the payments. The premise being that it's all under 409A, so we (inaudible) make it all non-comply (ph).

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

That's right. But for this person, for this arrangement, that rule sort of applies sort of arrangement by arrangement.

Mark Wincek - *Kilpatrick Stockton - Partner, Benefit and Compensation Practice*

I was at a meeting where Anne Marks (ph) was talking about 409A and, I think, she was saying that she's not directly involved but she likes the fact that people who have a good grounding in qualified plans are involved. And, to her, she said that meant that at some point there would be an EPCRS (ph) for 409A. That's kind of the way we think we're not intending to have a kind of gotcha kind of environment. We want to have good rules and firm rules. We don't think that having EPCRS kind of flexibility eventually is out of the question. Could you comment on that?

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

Yeah. That's really kind of an IRS resources issues, so she would know a lot more about that than I do. Obviously, I think that's a good idea. But, it really is a resources issue. Historically, the exec comp group is pretty lean over there, so they definitely need to staff up to administer that sort of thing.

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Mark Wincek - *Kilpatrick Stockton - Partner, Benefit and Compensation Practice*

And I should just footnote my last comment by saying that when I refer to EPCRS, I'm referring to the program that the IRS has developed that allows corrections to be made in qualified plans and that provides for a more limited sanctions as long as corrections are done in accordance with the rules. With that, we're going to bring this call to a close. And, I really appreciate, Dan, your participation today. I think we've learned a lot of very helpful information and maybe on a two points, we pass the long arm on the jewel go back and get some use out of it as well. But, thank you very much.

Dan Hogans - *US Department of Treasury - Attorney Advisor in the Office of Tax Politics*

Thank you. Good questions as always.

Mark Wincek - *Kilpatrick Stockton - Partner, Benefit and Compensation Practice*

And let me just say that the last time I checked I did slip out part of the way through to see if the alert was on the flex side our legal alert did not appear to be last time that I checked. So, I would encourage anyone who would like to get a copy of the legal alert provide pretty good summaries, gets into some detail, and would be happy to send that along to you, if you would just send us an email at the email address for questions, and I think, in time it will be on the website as well. And, Michael, back to you.

Michael Wyatt - *WellPoint Inc. - Vice President and Deputy General Council and*

Thank you. I would also like to thank our panelists, Dan, Mark and Lois and Jennifer for your time as well as our listeners for participating today. We hope you have found this program enlightening, and again, thanks to all for your participation.

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